

RIGHTS OF VARIOUS TYPES OF CREDITORS IN PROPERTY UNAVAILABLE TO THE DEBTOR

WHEN SATISFACTION cannot be obtained out of the general assets of a debtor, creditors will often attempt to realize on claims which are not available to the debtor himself. Some of these claims arise out of transactions which injure debtor and creditors alike; others grow out of dealings which work injury only to creditors. While in appropriate circumstances these transactions will give rise to a cause of action,¹ that cause of action will be vested not in all creditors, but only in those who are deemed to be injured. For the purposes of this comment it will be assumed that all of the other elements of recovery are present; an attempt will then be made to determine what sort of creditor may, and what sort may not, realize on the various claims unavailable to the debtor.² Further investigation will be made of the assertion of such claims by a representative of creditors; for on such occasions similar questions are raised, though they are framed in terms of the extent of the representative's recovery, and the methods of distributing the recaptured property.

A creditor who attempts to recover on claims unavailable to the debtor will normally rely on one of two theories. In situations falling under the first theory the debtor appears to be in command of greater resources than are actually at his disposal—a misleading impression that is created through the complicity, or at least passive acquiescence, of a third party. The basis of recovery, then, will be that credit was extended in reliance on the misrepresentations attributable to that party. Accordingly the creditor will have to show as a minimum that he extended credit subsequent to the creation and prior to the termination of the appearance of greater resources; and any actual knowledge of the true state of the debtor's affairs will preclude recovery.

In transactions of the second type—broadly classified as fraudulent conveyances—the debtor has in some way dissipated his assets. The basis of the cause of action will be that creditors have been deprived of some assets which were available to satisfy their claims. But this theory will grant protection only to creditors whose claims were in existence at the time of the transaction; creditors who extended credit to a debtor with already depleted assets cannot ordinarily recover. Such creditors will be granted a right of action only if they are able to show that the debtor intended to defraud them

1. See, generally, materials cited in notes 6, 10, 13, 40, 57, *infra*.

2. Some of the fact situations dealt with can involve only corporate debtors. In order to insure the validity of the comparisons made, cases involving such debtors have been used in all situations as far as possible. But since such cases are not everywhere to be found, it has been thought best not expressly to limit the subject-matter of the comment to corporate debtors.

—a theory of recovery somewhat similar to that advanced in the "apparent ownership" cases.

Aside from these general theories, one other factor may operate to discriminate between creditors. It is usually said that, before making a claim which is unavailable to the debtor, the creditor must have exhausted his remedies against the general assets.³ But this requisite does not make for any fundamental distinction between creditors; rather it imposes a procedural obstacle which any creditor can normally surmount. In any case the "exhaustion" requirement has received a liberal interpretation with comparative uniformity; wherever it seemed superfluous, it has been relaxed.⁴ In somewhat the same way the courts have searched out ways of avoiding the general theoretical requirements in cases of apparent merit. But far from achieving uniformity in this respect, the methods of escape have varied not only with particular courts, but with the particular transaction as well. The types of creditors who may recover can thus be determined only by an examination of each of the more commonly recurring claims.

Since property subject to a mortgage or conditional sale agreement is generally retained in the possession of the debtor, he may appear to be endowed with the attributes of complete ownership. Creditors who assert that they have extended credit on the faith of this apparent ownership may attempt to avoid the mortgage on the ground that the mortgagee was a party to the deception. Since a claim of this nature could conceivably be made wherever a debtor's property was mortgaged, recording statutes were evolved to define the rights of the parties more precisely.⁵ The reliance theory runs through these statutes, but only in incomplete form. Thus when a mortgage is duly recorded, recovery by creditors is precluded; recordation is deemed to convey knowledge to all the world and thus to negate any intent to deceive as

3. *Braun v. American Laundry Mach. Co.*, 56 F. (2d) 197 (S. D. N. Y. 1932). Strictly this rule requires that the creditor obtain a judgment against the debtor and that execution be returned unsatisfied. *Hannan v. Hardee*, 69 F. (2d) 394 (App. D. C. 1934).

4. *Gaskins v. Bonfils*, 8 F. Supp. 832 (D. Colo. 1934). Thus insolvency of the debtor generally obviates the requirement. *Williams' Ex'r v. Chamberlain*, 123 Ky. 150, 94 S. W. 29 (1906). Likewise a trustee in bankruptcy need not prove that he represents judgment creditors. *Williams v. Brownstein*, 1 F. (2d) 470 (D. Me. 1924); *Union Trust Co. v. Amery*, 67 Wash. 1, 120 Pac. 539 (1912). The same may be true of a state court receiver. See *v. Heppenheimer*, 69 N. J. Eq. 36, 61 Atl. 843 (Ch. 1905); *cf. Cooney Co. v. Arlington Hotel Co.*, 11 Del. Ch. 430, 106 Atl. 39 (Sup. Ct. 1918). But *cf. Sharp v. Hawks*, 80 F. (2d) 731 (C. C. A. 8th, 1936) (federal court receiver); *Commerce Trust Co. v. Woodbury*, 77 F. (2d) 478, 488 (C. C. A. 8th, 1935). And a trustee should not have to allege exhaustion of corporate assets. *Benner v. Billings*, 107 Wash. 1, 181 Pac. 19 (1919). For the effect of the Amendment of 1910 to § 47(a) of the Bankruptcy Act, see *McLean v. Green*, 171 Miss. 183, 157 So. 251 (1934). Under the Uniform Fraudulent Conveyance Act even a judgment is not necessary before a creditor may move to set aside a fraudulent transfer as there defined. *American Surety Co. v. Conner*, 251 N. Y. 1, 166 N. E. 783 (1929); see Glenn, *The Uniform Fraudulent Conveyance Act; Rights of Creditor Without Judgment* (1930) 30 COL. L. REV. 202.

5. See WALSH, *MORTGAGES* (1934) § 28 *et seq.*; *cf. Comment* (1928) 37 YALE L. J. 494.

well as the possibility of reliance.⁶ When the mortgage is not recorded, recovery is still limited to those who could possibly have relied. Accordingly a creditor must show that his claim arose after the mortgage was executed and before it was recorded. But once this is demonstrated, no further proof of reliance is necessary;⁷ the creditor will be automatically protected unless there is a showing that he knew of the mortgage agreement. Further statutory delimitation of the right to recover bears no relation to the reliance theory; this may be said of the requirement in the majority of statutes that a lien be acquired before recordation.⁸ And completely inconsistent with the theory is the occasional decision holding a mortgage invalid as against a creditor whose claim arose before the agreement was made, but who obtained a lien in the period between the execution of the agreement and its recordation.⁹

Closely related to the unrecorded mortgage is the type of situation where the debtor is in apparent ownership of property, though he is under an equitable or even moral obligation to transfer it to the real owner. Such obligations can not be recorded; and if the equitable owner has allowed the debtor to treat the property as his so as to invite credit on that basis, creditors who "relied" on this representation may be able to make a good claim against the property.¹⁰ But unlike the case of the unrecorded mortgage, where the mere failure to record is sufficient to give rise to a general right of recovery, there must be an actual showing of the specific acts or omissions of the equitable owner tending to reveal bad faith and to put the debtor in apparently complete ownership.¹¹ Once the general cause of action has been established, distinctions are made between creditors purely on a basis of possible reliance. So long as a claimant has shown that he extended credit after the creation and before the termination of the equitable obligation, no proof of actual reliance will be required.¹²

6. See Comment (1919) 28 YALE L. J. 685.

7. *Becker Co. v. Gill*, 206 Fed. 36 (C. C. A. 8th, 1913); *Townsend v. Ashepoo Fertilizer Co.*, 212 Fed. 97 (C. C. A. 4th, 1914); *Ruggles v. Cannedy*, 127 Cal. 290, 53 Pac. 911, 59 Pac. 827 (1899); *Klingensmith v. Clow & Sons*, 273 Mich. 48, 262 N. W. 644 (1935); *American Multigraph Sales Co. v. Jones*, 58 Wash. 619, 109 Pac. 108 (1910); *Ryan Drug Co. v. Hvambzahl*, 89 Wis. 61, 61 N. W. 299 (1894).

8. *Morey & Co. v. Schaad*, 98 N. J. L. 799, 121 Atl. 622 (1923); see UNIFORM CONDITIONAL SALES ACT § 5; UNIFORM CHATTEL MORTGAGE ACT § 42-2 (not yet adopted in any state). If bankruptcy proceedings are instituted before the recordation of the mortgage, the trustee, as a lien creditor, may set the mortgage aside. *In re Master Knitting Corp.*, 7 F. (2d) 11 (C. C. A. 2d, 1925); *In re Frost*, 12 F. (2d) 1 (C. C. A. 6th, 1926); *In re Douglas Lumber Co.*, 2 F. (2d) 985 (D. Wyo. 1924); cf. *Olson & Co. v. Voorhees*, 292 Fed. 113 (C. C. A. 3d, 1923) (receiver).

9. *Cardenas v. Miller*, 108 Cal. 250, 39 Pac. 783, 41 Pac. 472 (1895). But cf. *Bornstein & Sons v. Allen*, 127 Wash. 314, 220 Pac. 801 (1923) (prior creditor not protected).

10. See, generally, *Carey and Cilella, Protection of Creditors by Estoppel* (1935) 29 ILL. L. REV. 1000.

11. See *id.* at 1015-1017.

12. Actual reliance occasionally appears, without any suggestion as to its necessity. *Hart v. Casterton*, 56 N. D. 581, 218 N. W. 644 (1928). In one case, however, it is

Another general type of claim theoretically available only to relying creditors is that against the holder of watered stock.¹³ Stock is said to be watered when it has been issued as fully paid, though not so paid.¹⁴ In such cases the paid-in capital does not equal the represented capital, and each stockholder is said to be a party to the misrepresentation to the extent of the unpaid balance on his stock.¹⁵ Creditors who have "relied" on this representation will be able to recover from the holders of watered stock.¹⁶ Under this theory of recovery the creditor's claim must, of course, have arisen subsequently to the issuance of stock;¹⁷ a creditor existing at the time is said not to be prejudiced, since the assets were not depleted. If the creditor has proved subsequence, courts follow the tendency of the recording statutes by generally presuming reliance.¹⁸ Whether or not this presumption is expressly recognized, no case has been found where any evidence was required that the creditor actually relied on, or even knew of, the corporation's stated paid-up

arguable that the court denied recovery because no reliance was shown. *Bergin v. Blackwood*, 141 Minn. 325, 170 N. W. 508 (1919).

13. See, generally, *Bonbright, Stockholders' Defenses Against Liability to Creditors on Watered Stock* (1925) 25 COL. L. REV. 403; *Comments* (1936) 35 MICH. L. REV. 103; (1929) 17 CALIF. L. REV. 290.

14. It is largely immaterial whether the stock was issued for no consideration, as by way of bonus [*Stoecker v. Goodman*, 183 Ky. 330, 209 S. W. 374 (1919)], or for a payment of a certain percentage of par [*Vermont Marble Co. v. Delez Granite Co.*, 135 Cal. 579, 67 Pac. 1057 (1902)], or in return for property which is grossly overvalued. *Berry v. Rood*, 168 Mo. 316, 67 S. W. 644 (1902). But it has been held that stock which is issued for no consideration at all is wholly void and the holder of it not liable. *Hirshfeld v. McKinley*, 78 F. (2d) 124 (C. C. A. 9th, 1935), (1936) 3 U. OF CHI. L. REV. 331.

The more reasonable rule seems to be that the creditor must prove that par value was not paid. *Yardley v. Caruthersville Motor Co.*, 225 Mo. App. 321, 35 S. W. (2d) 971 (1931); *Thomas v. Scoutt*, 115 Neb. 848, 215 N. W. 140 (1927). *Contra*: *Ryerson & Son v. Peden*, 303 Ill. 171, 135 N. E. 423 (1922); *Goff v. Goff & Co.'s Assignee*, 257 Ky. 519, 78 S. W. (2d) 758 (1935). In the case of no-par stock the deficiency is the difference between the amount stated to have been and the amount actually paid in. *Livingston v. Adams*, 226 Mo. App. 824, 43 S. W. (2d) 836 (1931). Theories as to the proper measure of deficiency vary widely. Compare *Strickland v. Washington Bldg. Corp.*, 287 Ill. App. 340, 4 N. E. (2d) 973 (1936) ("actual value" rule), with *Krebs v. Oberrender*, 274 Pa. 154, 118 Atl. 19 (1922) ("good faith" rule); see, generally, *State Trust Co. v. Turner*, 111 Iowa 664, 82 N. W. 1029 (1900); 2 BONBRIGHT, *THE VALUATION OF PROPERTY* (1937) 790-810.

15. Accordingly the stockholder must have knowledge that the stock is not fully paid. *Rhode v. Dock-Hop Co.*, 184 Cal. 367, 194 Pac. 11 (1920). Generally there must be at least a showing that the stockholder bought directly from the corporation. *Gray Const. Co. v. Fantle*, 62 S. D. 345, 253 N. W. 464 (1934). But *cf.* *Shugart v. Maytag*, 188 Iowa 916, 176 N. W. 886 (1920). Where an innocent transferee of stock is protected, the transferor with knowledge may be liable. *Enright v. Heckscher*, 240 Fed. 863 (C. C. A. 2d, 1917).

16. *Hospes v. Northwestern Mfg. & Car Co.*, 48 Minn. 174, 50 N. W. 1117 (1892).

17. *Handley v. Stutz*, 139 U. S. 417 (1891); *Coit v. Gold Amalgamating Co.*, 119 U. S. 343 (1886).

18. *Handley v. Stutz*, 139 U. S. 417 (1891); see *See v. Heppenheimer*, 69 N. J. Eq. 36, 84, 61 Atl. 843, 862 (Ch. 1905); *cf.* *Lex v. Selway Steel Corp.*, 203 Iowa 792, 814, 206 N. W. 586, 596 (1925).

capital.¹⁹ Instead the burden of proof is upon the defendant stockholder to negative reliance by showing that the creditor knew of the stock watering.²⁰ Though there is a wide divergence, courts are generally slow to find knowledge. Since it will normally be difficult to furnish incontrovertible proof of actual knowledge, inferences must be drawn from surrounding circumstances. Thus, as might be expected, the courts deny recovery where the creditor was a promoter of the corporation or its attorney,²¹ and generally where he was a director or himself a holder of watered stock.²² On occasion an accurate public record of the corporation's affairs, like a recorded mortgage, has been declared to put creditors on notice.²³ But knowledge will not be inferred from general familiarity with the corporation²⁴ or from many years' dealings with notoriously over-capitalized corporations such as wildcat oil producers.²⁵

19. Where it was not possible for the creditor to have acted in reliance, however, recovery has been denied, as where the debtor corporation was the assignee of a leasehold and the creditor was the lessor. *Bobb v. Walmar Theater Co.*, 206 Mo. App. 236, 227 S. W. 841 (1921). Tort creditors would fall in this category, but may be allowed to recover if the right of action on watered stock is based on a statute. *Kelly v. Fourth of July Mining Co.*, 21 Mont. 291, 53 Pac. 959 (1898); cf. cases cited in note 30, *infra*. Such creditors might not be barred in the unrecorded mortgage situations, since the statutory requirement of subsequence is there purely mechanical. See note 7, *supra*.

20. *Northwestern Mut. Life Ins. Co. v. Cotton Exchange Real Estate Co.*, 46 Fed. 22 (C. C. E. D. Mo. 1891); *Scott v. Barton*, 285 Mo. 427, 226 S. W. 958 (1920); *Smith v. Schmitt*, 112 Ore. 687, 231 Pac. 176 (1924). *Contra*: *Colville Valley Coal Co. v. Rogers*, 123 Wash. 360, 212 Pac. 732 (1923).

21. *Promoter*: *Martin v. South Salem Land Co.*, 94 Va. 28, 26 S. E. 591 (1896); cf. *Whalen v. Hudson Hotel Co.*, 183 App. Div. 316, 170 N. Y. Supp. 855 (3d Dep't 1918). *Attorney*: *Johnson v. Tennessee Oil Co.*, 74 N. J. Eq. 32, 69 Atl. 788 (Ch. 1903).

22. *Reel v. Brammer*, 56 Ind. App. 180, 101 N. E. 1043 (1913); *Miller v. Higginbotham's Adm'r*, 29 Ky. L. 547, 93 S. W. 655 (1906); *Biggs v. Westen*, 248 Mo. 333, 154 S. W. 708 (1913). But sometimes even a stockholder who sold overvalued property to the corporation in return for stock may not be held to notice of the deal. *Martin v. South Salem Land Co.*, 94 Va. 28, 26 S. E. 591 (1896); cf. *Stoecker v. Goodman*, 183 Ky. 330, 209 S. W. 374 (1919).

Rules for the imputation of the knowledge of its officers to a creditor corporation are orthodox. *Sherman v. Harley*, 178 Cal. 584, 174 Pac. 901 (1918); *First Nat. Bank of Chanute v. Northrup*, 82 Kan. 638, 109 Pac. 672 (1910); cf. *Watt v. German Savings Bank*, 183 Iowa 346, 165 N. W. 897 (1917).

23. *Bent v. Underdown*, 156 Ind. 516, 60 N. E. 307 (1901) (articles of association). But cf. *Stout v. Hubbell*, 104 Iowa 499, 73 N. W. 1060 (1898).

24. See cases cited note 25, *infra*. But cf. *Farrell v. Davis*, 85 Ore. 213, 161 Pac. 94 (1916).

25. One company repeatedly claimed it had been deceived by such companies. *California National Supply Co. v. Black*, 48 Cal. App. 122, 191 Pac. 715 (1920); *Cal. Nat. Sup. Co. v. O'Brien*, 51 Cal. App. 606, 197 Pac. 414 (1921); *Cal. Nat. Sup. Co. v. Dinsmore*, 52 Cal. App. 513, 199 Pac. 552 (1921). Occasionally, however, mining companies have been treated as in a special class. *In re South Mountain Consolidated Mining Co.*, 5 Fed. 403 (C. C. D. Cal. 1881); *Ross v. Silver & Copper Island Min. Co.*, 36 Minn. 38, 29 N. W. 591 (1886). But cf. *Kelly v. Fourth of July Min. Co.*, 21 Mont. 291, 53 Pac. 959 (1898).

The reluctance of the courts to find knowledge perhaps reflects the decadence of the reliance theory.

While the rigor of the reliance rule has been relaxed, it will at least operate to deny recovery to already existing creditors, and to those who are deemed to have knowledge. By resort to varied devices even such creditors have sometimes been able to induce courts to allow them recovery. Most frequently these attempts have taken the direction of framing the case in terms of an action to collect unpaid subscriptions. Such claims are of course available to the corporation,²⁶ and a creditor recovering from a stockholder on this basis does so in the corporation's right.²⁷ Any creditor, existing as well as subsequent, with or without knowledge, may bring the action.²⁸ Accordingly, at least three jurisdictions have allowed creditors who knew of or even participated in the stock watering to recover by the simple expedient of holding an agreement to consider part payment as full payment void as against the corporation.²⁹ This leaves the full subscription obligation in force and available to any creditor. A similar result has been obtained elsewhere, without declaring such agreements void as to the corporation, by a judicious application of ordinary statutes requiring capital stock to be paid up. Stockholders are held to be unable by any agreements with the corporation to avoid their obligation to creditors to pay the full amount of the stock.³⁰ A different expedient for the existing creditor may be found when promoters have made substantial profits by selling property to the debtor corporation at inflated values, in return for corporate securities. Although earlier indications were unfavorable,³¹ it is definitely the import of the recent case of

26. See, generally, Comment (1935) 33 MICH. L. REV. 1059.

27. *Geigy Co. v. Wilfling*, 50 R. I. 506, 149 Atl. 609 (1930). Thus where the corporation's right is barred, as by the Statute of Limitations, the creditor may be helpless. *Hawkins v. Donnerberg*, 40 Ore. 97, 66 Pac. 691 (1901); *Spencer v. Anderson*, 193 Cal. 1, 222 Pac. 355 (1924).

28. *Thielsen v. Linde*, 127 Ore. 639, 271 Pac. 983 (1928); see *Sprague v. Nat. Bank of America*, 172 Ill. 149, 168, 50 N. E. 19, 26 (1898).

But in certain unpaid subscription cases, where the stockholder might have had a good defense against the corporation which he cannot assert against the creditor, the type of creditor involved becomes relevant. *Lex v. Selway Steel Corp.*, 203 Iowa 792, 206 N. W. 586 (1925) (subscription agreement subject to rescission unknown to subsequent creditor); cf. *Butts v. King*, 101 Conn. 291, 125 Atl. 654 (1924) (novation of subscription obligation, like fraudulent transfer, ineffective as against existing creditor).

29. *Rosoff v. Gilbert Transportation Co.*, 221 Fed. 972 (D. Conn. 1915); *Cooney Co. v. Arlington Hotel Co.*, 11 Del. Ch. 430, 106 Atl. 39 (Sup. Ct. 1918); *Easton Nat. Bank v. Amer. Brick & Tile Co.*, 70 N. J. Eq. 732, 64 Atl. 917 (1906).

30. *Frink v. Carman Distributing Co.*, 97 Colo. 211, 48 P. (2d) 805 (1935); *Stoecker v. Goodman*, 183 Ky. 330, 209 S. W. 374 (1919); *Gillett v. Chicago Title & Trust Co.*, 230 Ill. 373, 82 N. E. 891 (1907); cf. *Clark v. Tompkins*, 205 Cal. 373, 270 Pac. 946 (1928); *Bottlers' Seal Co. v. Rainey*, 243 N. Y. 333, 153 N. E. 437 (1926).

31. *Priest v. White*, 89 Mo. 609, 1 S. W. 361 (1886); see *Banque Franco-Egyptienne v. Brown*, 34 Fed. 162, 196 (C. C. S. D. N. Y. 1883); *Allenhurst Park Estates, Inc. v. Smith*, 101 N. J. Eq. 581, 596, 138 Atl. 709, 716 (Ch. 1927).

*McCandless v. Furlaud*³² that creditors may recover from the promoters, at least through a receiver, and that existing creditors are in the more favorable position. This alternative is of course available only as against promoters, who, in any case, have intricate defenses available.³³ One further possibility for avoiding the discrimination against existing creditors might lie in the use of the so-called trust fund doctrine. As originally stated, the doctrine declared the capital stock of a corporation to be a trust fund for all creditors.³⁴ Definitely discredited, at least in this unqualified form,³⁵ it still occasions considerable confusion, for it persistently reappears in the cases³⁶ though apparently only as a substitute for the reliance theory.³⁷ But since unpaid subscriptions are considered as capital for purposes of this theory,³⁸ it might conceivably be argued that a loss of this "fund" by agreements with stockholders would give a right of action to all creditors. No court has as yet adopted this rationale.

When a transaction is regarded by the courts as something akin to a fraudulent conveyance, the right of action is limited to existing creditors unless an intent to defraud subsequent creditors can be shown.³⁹ But many of the transactions that are treated as fraudulent conveyances to some extent resemble the issuance of watered stock. This is especially true of the first type of transaction to be considered, the repurchase of stock by the corporation.⁴⁰ Repurchase may be effected either by payment of cash, or by the cancellation of unpaid subscription balances, or by the issuance of secured or unsecured obligations. The rights of various creditors to void these transactions may thus arise either when the creditors attempt to recover from the stockholders,⁴¹ or to collect the subscriptions,⁴² or when the stockholders

32. 296 U. S. 140 (1935), (1936) 49 HARV. L. REV. 785.

33. See, generally, Comment (1936) 45 YALE L. J. 511.

34. See Story, J., in *Wood v. Dummer*, 30 Fed. Cas. No. 17,944 (C. C. D. Me. 1824); Hunt, *The Trust Fund Theory and Some Substitutes for It* (1902) 12 YALE L. J. 63.

35. *Coit v. Gold Amalgamating Co.*, 119 U. S. 343 (1886); *Hospes v. Northwestern Mfg. & Car Co.*, 48 Minn. 174, 50 N. W. 1117 (1892); cf. *McDonald v. Williams*, 174 U. S. 397 (1899); *O'Bear Jewelry Co. v. Volfer*, 106 Ala. 205, 17 So. 525 (1895).

36. This is true throughout the field of this Comment. See, e.g., *Valhalla Memorial Park Co. v. Lowry*, 209 Ind. 423, 428, 199 N. E. 247, 249 (1936); cf. notes 51, 54, 65, *infra*.

37. E.g., *Rhode v. Dock-Hop Co.*, 184 Cal. 367, 194 Pac. 11 (1920); *Courtney v. Youngs*, 202 Mich. 384, 168 N. W. 441 (1918); *Johnson v. Tennessee Oil Co.*, 74 N. J. Eq. 32, 69 Atl. 788 (Ch. 1908).

38. See *Fogg v. Blair*, 139 U. S. 118, 125 (1891); *Forcum v. Symmes*, 106 Fla. 510, 514, 143 So. 630, 632 (1932); cf. *Wagner v. Eisenmenger*, 65 S. W. (2d) 108 (Mo. App. 1933).

39. See, generally, GLENN, FRAUDULENT CONVEYANCES (1931) 423-466.

40. See Comment (1936) 20 MINN. L. REV. 422; (1933) 42 YALE L. J. 1128.

41. E.g., *Lefker v. Harner*, 123 Ark. 575, 186 S. W. 75 (1916); *Atlanta & Walworth Butter & Cheese Ass'n v. Smith*, 141 Wis. 377, 123 N. W. 106 (1909); *Union Trust Co. v. Amery*, 67 Wash. 1, 120 Pac. 539 (1912).

42. E.g., *Alabama Terminal & Improvement Co. v. Hall & Farley*, 152 Ala. 262, 44 So. 592 (1907); *Forcum v. Symmes*, 106 Fla. 510, 143 So. 630 (1932).

seek to enforce the corporate obligations in bankruptcy or receivership over the protest of creditors.⁴³ Such transactions are not invalid as against the creditor,⁴⁴ unless the corporation was insolvent at the time or the transaction rendered it so.⁴⁵

Under the prevailing notion stock repurchases are treated as fraudulent conveyances. Attacks may be made only by existing creditors,⁴⁶ unless actual intent to defraud subsequent creditors is shown. Of course even existing creditors who knew of or participated in the transaction may be estopped from complaining of the dissipation of the corporate assets.⁴⁷ Though recovery is generally limited to the existing creditor, a substantial number of courts have found ways to grant the subsequent creditor a remedy. Thus courts have occasionally resorted to the expedient of finding repurchase agreements *ultra vires* and unenforceable.⁴⁸ This device may be resorted to only when the repurchase agreement is still executory, but other contrivances used by the courts have a broader application. Sometimes courts have slurred over the elements of the cause of action and have seemed to suggest that the status of the creditor as existing and the corporation's insolvency

43. *E.g.*, *Durand v. Brown*, 236 Fed. 609 (C. C. A. 6th, 1916); *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 N. E. 267 (1932).

44. If the corporation is solvent it may repurchase its own stock. See Wormser, *The Power of a Corporation to Acquire Its Own Stock* (1915) 24 YALE L. J. 177. But *cf. In re Burnet-Clark Ltd.*, 56 F. (2d) 744, 747 (C. C. A. 2d, 1932). The English rule is to the contrary. *Trevor v. Whitworth*, 12 App. Cas. 409 (1837). Although probably fallacious, the argument has been made that a contract for repurchase is unenforceable for lack of mutuality since it might be unlawful for the corporation to perform it except out of surplus. *Topken, Loring & Schwartz v. Schwartz*, 249 N. Y. 206, 163 N. E. 735 (1928), (1929) 42 HARV. L. REV. 829. See note 45, *infra*.

45. *Bunker Hill Country Club v. McElhatton*, 282 Ill. App. 221 (1935); *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 N. E. 267 (1932); see *Sanford v. First Nat. Bank of Marysville, Kan.*, 238 Fed. 298, 301 (C. C. A. 8th, 1916); but *cf. Marshall v. Fredericksburg Lumber Co.*, 162 Va. 136, 173 S. E. 553 (1934). A note given in repurchase is at no time enforceable unless it can be paid out of surplus. *In re Fechheimer Fishel Co.*, 212 Fed. 357 (C. C. A. 2d, 1914). *Contra: Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 N. E. 267 (1932).

46. *Durand v. Brown*, 236 Fed. 609 (C. C. A. 6th, 1916); *Sanford v. First Nat. Bank of Marysville, Kan.*, 238 Fed. 298 (C. C. A. 8th, 1916); *Cohen v. George*, 149 Ga. 701, 101 S. E. 803 (1920); *Long v. Lynch Enterprise Finance Corp.*, 39 Ga. App. 221, 146 S. E. 513 (1929); *Bunker Hill Country Club v. McElhatton*, 282 Ill. App. 221 (1935); *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 N. E. 267 (1932).

47. *Cf. Way v. Ruff*, 112 Minn. 57, 127 N. W. 564 (1910); see *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 176, 182 N. E. 267, 269 (1932). If an estoppel is not raised the result may be disturbing. For example, on the basis of a strong statute the Michigan court allowed a bank which had knowingly loaned the corporation money with which to repurchase its stock to recover from a former stockholder. *First Nat. Bank of Boyne City v. A. Heller Sawdust Co.*, 240 Mich. 688, 216 N. W. 464 (1927); see note 50, *infra*. It was suggested, however, that if the bank also had had knowledge of the corporation's financial condition a different result might have been reached.

48. *Hamor v. Taylor-Rice Engineering Co.*, 84 Fed. 392 (C. C. D. Del. 1897); *cf. note 44, supra*.

are alternative allegations, that only one would be sufficient.⁴⁰ With the help of perfectly usual statutes⁵⁰ and the trust fund doctrine, which always tends to equalize creditors, some courts have simply stated that repurchase was in fraud of subsequent creditors.⁵¹ Other courts have allowed subsequent creditors to recover by giving full effect to the notion of intent to defraud. Wisconsin, for example, has held that where the contracting parties to the repurchase agreement contemplated that the sinking corporation would continue to incur debts as solvent, repurchases were so lacking in good faith as to supply the actual intent to defraud.⁵² It will be seen that this approaches the "reliance" concept, and several other courts have found that creditors were entitled to assume that the capital paid in would not be paid out again except in the legitimate course of business, and that the stockholder may be a party to creating this deceptive appearance.⁵³ If this line of argument is used in a case where the corporation sought merely to cancel its right to collect subscriptions, the case becomes almost indistinguishable from a typical watered stock case, and properly so. For no apparent reason, however, the courts are reluctant to use the reliance doctrine explicitly; seemingly they prefer to resort to the ubiquitous trust fund theory.⁵⁴ Perhaps partly in consequence, if a subsequent creditor is to be allowed to set aside a repurchase of stock, the effect of his knowledge of the transaction has not been determined. In general such knowledge appears to lessen the chances for recovery, but since it has always been used in connection with some other factor of defense, its exact effect is indeterminate. In several recent decisions, however, it has clearly been an important element in allowing a stockholder

49. *Banker Hill Country Club v. McElhatton*, 282 Ill. App. 221 (1935); *Campbell v. Grant Trust & Savings Co.*, 97 Ind. App. 169, 182 N. E. 267 (1932). Often no mention is made of the status of creditors. *In re Smith Lumber Co.*, 132 Fed. 618 (N. D. Tex. 1904); *Moore & Co. v. Gilmore*, 216 Fed. 99 (C. C. A. 4th, 1914).

50. The most stringent type of statute provides that if the capital stock shall be withdrawn and refunded to the stockholders before the payment of all debts the stockholders shall be liable to "any creditor." MICH. COMP. LAWS (1929) § 10018; *First Nat. Bank of Boyne City v. Heller Sawdust Co.*, 240 Mich. 688, 216 N. W. 464 (1927). But this statute is not typical.

51. *Williams v. Brownstein*, 1 F. (2d) 470 (D. Me. 1924); *Lefker v. Harner*, 123 Ark. 575, 186 S. W. 75 (1916).

52. *Atlanta & Walworth Butter & Cheese Ass'n v. Smith*, 141 Wis. 377, 123 N. W. 106 (1909).

53. *Coleman v. Tepel*, 230 Fed. 63 (C. C. A. 3d, 1916); *Alabama Terminal & Imp. Co. v. Hall*, 152 Ala. 262, 44 So. 592 (1907); *Union Trust Co. v. Amery*, 67 Wash. 1, 120 Pac. 539 (1912); cf. *In re Fechheimer Fishel Co.*, 212 Fed. 357 (C. C. A. 2d, 1914); *In re O'Gara & Maguire*, 259 Fed. 935 (D. N. J. 1919); see *First Trust Co. v. Illinois Central R. R.*, 256 Fed. 830, 831 (C. C. A. 8th, 1919), *cert. denied*, 249 U. S. 615 (1919).

If a stockholder can show that he is innocent of the nature of the transaction, creditors seeking to recover on the "reliance" basis might be confronted with a formidable logical obstacle. See note 15, *supra*.

54. *Williams v. Brownstein*, 1 F. (2d) 470 (D. Me. 1924); *In re O'Gara & Maguire*, 259 Fed. 935 (D. N. J. 1919); *Olmstead v. Vance & Jones Co.*, 196 Ill. 236, 63 N. E. 634 (1902).

to collect on a repurchase agreement.⁵⁵ Even if the reliance theory is not used, subsequent creditors with knowledge, like existing creditors, might well be estopped from complaining.⁵⁶

The payment of dividends to stockholders where the corporation is in difficulties is perhaps even more suspect than the repurchase of stock, since there is generally no pretense that the corporation has received anything in return for the dividend.⁵⁷ Fraudulent conveyance concepts are even more dominant; though in addition to the preexisting or resulting insolvency of the corporation,⁵⁸ the guilty knowledge of the stockholder is a generally required element in the cause of action.⁵⁹ Thus the standard rule seems to be that recovery may be had only if the creditor's claim arose before the dividend was paid.⁶⁰ And as in the case of stock repurchases a creditor may be estopped if he had tacitly or otherwise consented to the payment of the dividend.⁶¹ Of course, a showing of "actual intent" to defraud will permit subsequent creditors to recover,⁶² but the practical difficulties are notoriously great. Again sympathetic judges have sought to aid the subsequent creditor in other ways. The category of existing creditors has been widened to include those who extended credit before the distribution of the dividend, although after its declaration.⁶³ With various doctrinal justifications, several courts have departed completely from the rule. In one case a statute apparently intended to apply to stock repurchase was used to allow a single creditor to recover dividends that had been paid before, as well as after the debt

55. *First Trust Co. v. Illinois Central R. R.*, 256 Fed. 830 (C. C. A. 8th, 1919), *cert. denied*, 249 U. S. 615 (1919); *Scriggins v. Dalby Co.*, 290 Mass. 414, 195 N. E. 749 (1935); *Cross v. Beguelin*, 252 N. Y. 262, 169 N. E. 378 (1929), (1930) 39 *YALE L. J.* 902; *cf. Loveland & Co., Ltd. v. Doernbecher Mfg. Co.*, 149 Ore. 58, 39 P. (2d) 668 (1934).

56. See note 47, *supra*.

57. See generally, Comment (1933) 33 *COL. L. REV.* 481.

58. *McDonald v. Williams*, 174 U. S. 397 (1899); *Quintal v. Adler*, 146 Misc. 300, 262 N. Y. Supp. 126 (Sup. Ct. 1933). *Contra: Mente v. Groff*, 10 Ohio N. P. (N. S.) 148 (C. D. 1910).

59. *McDonald v. Williams*, 174 U. S. 397 (1899); *Bates v. Brooks*, 222 Iowa 1128, 270 N. W. 867 (1937). But *cf. Gratz v. Redd*, 4 B. Mon. 178 (Ky. 1843).

60. Thus, receiver or trustee must show that at least one of the creditors he represents was existing at the time of the dividend payment. *Wood v. National City Bank*, 24 F. (2d) 661 (C. C. A. 2d, 1928), (1929) 38 *YALE L. J.* 542; *Ratcliff v. Clendenin*, 232 Fed. 61 (C. C. A. 8th, 1916). But see 2 *COOK, LAW OF CORPORATIONS* (8th ed. 1923) § 548. For the moment the question as to the amount of recovery possible in this situation and its distribution is immaterial, and may be postponed. See p. 1179 *et seq.*, *infra*.

61. See *Lawrence v. Greenup*, 97 Fed. 906, 911 (C. C. A. 6th, 1899); *cf. Fort Madison Bank v. Alden*, 129 U. S. 372 (1889).

62. See *Wood v. National City Bank*, 24 F. (2d) 661, 663 (C. C. A. 2d, 1928). A court may find in the very payment of an unlawful dividend a defrauding of subsequent as well as existing creditors. *Fricke v. Angemeier*, 53 Ind. App. 140, 101 N. E. 329 (1913).

63. *Montgomery v. Whitehead*, 40 Colo. 320, 90 Pac. 509 (1907).

accrued.⁶⁴ Also the inevitable trust fund doctrine has been used to justify recovery by subsequent creditors. Sometimes the trust fund and reliance theories are found in unholy wedlock,⁶⁵ but a subsequent creditor could not safely embark on an action on the sole theory that he had relied on the capital stock being still intact. The one court that has stated reliance alone to be a good ground for recovery apparently could not visualize the transaction as a typical fraudulent conveyance and implied, perhaps unintentionally, that existing creditors could not recover.⁶⁶

This complete adherence to the theory of the watered stock cases would be clearly indicated when a stock dividend has been used, if the corporation were brazen enough to add the amount of the dividend to the paid-in capital account. Probably because few corporations would adopt such a procedure, suits have almost never been brought, but no reason appears why a subsequent creditor without knowledge might not be allowed to recover in that situation.⁶⁷ Since the assets would be in no way depleted, existing creditors would probably be held in no way prejudiced.

Closely related to the payment of dividends, but occurring typically upon the winding up of the corporation, is a type of transaction which may be identified as "distribution of assets." As usual the rules laid down, such as that "the distribution of a corporation's assets, leaving it incapable of discharging its debts, is fraudulent in the eyes of the law,"⁶⁸ settle almost nothing. But the problem here can scarcely be distinguished from that involved in the payment of unlawful dividends. The chief difference arises from the fact that generally there will be no subsequent creditors. If there are any such, they will probably know of the dissolution of the corporation. Hence the position of the subsequent creditor is well nigh hopeless,⁶⁹ except in the unlikely event that the distribution was made in bad faith with knowledge of the claim later to arise. Whether in consequence or not, cases display an extraordinary stretching of the concept of the existing creditor, at least in favor of the government. Thus the United States was allowed to recover from stockholders where a corporation dissolved after having been indicted

64. *American Steel & Wire Co. v. Eddy*, 130 Mich. 266, 89 N. W. 952 (1902); see note 50, *supra*.

65. *Williams v. Boice*, 38 N. J. Eq. 364 (Ch. 1884); *Cottrell v. Albany Card & Paper Mfg. Co.*, 142 App. Div. 148, 126 N. Y. Supp. 1070 (3d Dep't 1911); *cf. Shields v. Hobart*, 172 Mo. 491, 72 S. W. 669 (1903); *Rheinstrom v. Seasongood*, 19 Ohio N. P. (N. s.) 393 (Super. Ct. 1917).

66. *Mackall v. Pocock*, 136 Minn. 8, 161 N. W. 228 (1917).

67. *Whitlock v. Alexander*, 160 N. C. 465, 76 S. E. 538 (1912); see *Anglo-American Land Mortgage & Agency Co. v. Lombard*, 132 Fed. 721, 735 (C. C. A. 8th, 1904).

68. See *Bankers Trust Co. v. Hale & Kilburn Corp.*, 84 F. (2d) 401, 405 (C. C. A. 2d, 1936).

69. *Borough of Mt. Union v. Kunz*, 290 Pa. 356, 139 Atl. 118 (1927). But *cf. Brooks v. Buys*, 217 Mich. 263, 186 N. W. 472 (1922). An eight-judge court allowed subsequent creditors to recover but split evenly as to whether the transaction involved was stock-watering or distribution of assets.

under a federal law, but before conviction and the imposition of a penalty.⁷⁰ Where a retroactive tax was passed just after the dissolution of the corporation, the government was deemed to have been an existing creditor because it had held the power to levy the tax.⁷¹ But where the government sought to collect from stockholders a tax imposed on income earned after the transfer of assets, it was held to be a subsequent creditor and remediless.⁷²

Thus far the inquiry has been limited to the question of recovery in situations which may be to some extent classified. When attention is focused on the broad category usually termed preferences and fraudulent conveyances, no sort of grouping seems to be helpful. Not only do the types of conveyance vary, but the questions may arise in an almost unlimited number of different proceedings. The issues are often confused by such questions as solvency or the lack of it,⁷³ or the fraudulent intent of the debtor transferor or even of the transferee,⁷⁴ or whether a positive showing of good faith may sustain the transaction.⁷⁵ All these elements are reflected in the treatment of the types of creditors, and the *ad hoc* nature of the decisions makes the conclusions to be drawn uncertain at best. The basic rule, however, is laid down with what seems at first sight comforting finality. In the case of *Graham v. Railroad Co.*,⁷⁶ the United States Supreme Court held that where a corporate debtor disposed of property for the benefit of its officers, subsequent creditors were helpless unless they could show an intent to defraud.

The rule stands firm today,⁷⁷ but its interpretation has been far from uniform. Sometimes, it seems to have been applied with undue severity,

70. *Pierce v. United States*, 255 U. S. 398 (1921).

71. *United States v. Updike*, 1 F. (2d) 550 (D. Neb. 1924).

72. *Harwood v. Eaton*, 68 F. (2d) 12 (C. C. A. 2d, 1933).

73. *Oliver v. Quellmalz Lumber & Mfg. Co.*, 170 Ark. 1029, 282 S. W. 355 (1926); *Hamilton v. Menominee Falls Quarry Co.*, 106 Wis. 352, 81 N. W. 876 (1900); *cf. Nagel v. Farmers Exchange*, 64 S. D. 363, 266 N. W. 722 (1936).

74. *Irving Trust Co. v. Chase Nat. Bank of City of N. Y.*, 72 F. (2d) 668 (C. C. A. 2d, 1934); *Lohn v. Automatic Motor Control Corp.*, 155 Misc. 920, 281 N. Y. Supp. 642 (Sup. Ct. 1934).

Courts tend to be more receptive to creditors' claims where a claim preferred was that of an officer, director, or principal stockholder [*Rickerson Roller-Mill Co. v. Farrell Foundry & Mach. Co.*, 75 Fed. 554 (C. C. A. 6th, 1896); *Richards Co. v. The Mayfair*, 287 Mass. 280, 191 N. E. 430 (1934)] or one on which such a person was secondarily liable as indorser or surety. *Walker Bros. v. Eastern Motors Co.*, 70 Utah 543, 262 Pac. 97 (1927); *Ohio Finance Co. v. Mannington Window Glass Co.*, 86 W. Va. 322, 103 S. E. 333 (1920).

75. *Wabash Ry. v. Iowa & S. W. Ry.*, 200 Iowa 384, 202 N. W. 595 (1925). Thus financial necessity may be justification for a mortgage that otherwise might be fraudulent. *Arizona Corporation Comm. v. California Ins. Co.*, 28 Ariz. 128, 236 Pac. 460 (1925); *Smith v. Kornkven*, 64 N. D. 789, 256 N. W. 210 (1934); *Clarke Woodward Drug Co. v. Hot Lake Sanatorium Co.*, 88 Ore. 284, 169 Pac. 796 (1918); *cf. Handley v. Stutz*, 139 U. S. 417 (1891) (stock watering justified).

76. 102 U. S. 148 (1880).

77. *City of Fort Worth v. National Park Bank of N. Y.*, 261 Fed. 817 (C. C. A. 5th, 1919); *Phillips v. Carter*, 266 Fed. 444 (S. D. Ga. 1920); *Vickers v. Toerner*, 176 La.

as where the principal stockholder of a corporation drew personal checks on it and the trustee in bankruptcy was required to allege that each creditor was existing at the time each check was drawn.⁷⁸ Further, some courts have not always been alive to the possibilities of expanding the category of existing creditors. It is true that a creditor who has a claim normally need not have it liquidated or reduced to judgment before the transaction occurred, even though it be a tort claim.⁷⁹ But in determining when the transfer took effect the courts have generally adopted narrow interpretations. Thus in the case of a fraudulent mortgage it has been held that the making of the agreement, not the execution of the trust deed marks the time of the transfer,⁸⁰ and that where the mortgage agreement covers after-acquired property the creditor who is subsequent to the agreement is remediless.⁸¹ But on the whole the tendency, although not as marked as in other types of cases, has been to cut down the requirement that the claim be existing, and ingenious subsequent creditors have on occasion been allowed to recover. For example, where a failing corporation gave away a bill of sale to equipment but kept the equipment, the presumption of intent to defraud subsequent creditors was held to overcome general evidence of good faith.⁸² An analogy to the apparent ownership cases is clear. The Missouri court has used reliance—that the paid-up capital has remained intact—to eliminate the necessity of a trustee in bankruptcy alleging anything as to the status of the creditors represented by him,⁸³ but has been inconsistent as to whether there is a presumption of reliance.⁸⁴ In a recent Colorado case a complaint of a trustee which did not allege the previous existence of any creditors was sustained over a two-judge dissent based on the *Graham* case.⁸⁵ The defendants, who were the former owners of a small corporation overburdened by indebtedness, had

471, 146 So. 26 (1933); *Commercial Trust Co. v. Wertheim Coal & Coke Co.*, 88 N. J. Eq. 143, 102 Atl. 448 (Ch. 1917).

78. *Scales v. Holje*, 41 Cal. App. 733, 183 Pac. 308 (1919). Normally proof of one existing creditor is enough. Cf. note 60, *supra*. See p. 1179, *infra*.

79. *Valley Bank v. Malcolm*, 23 Ariz. 395, 204 Pac. 207 (1922); cf. *Hastings v. Drew*, 76 N. Y. 9 (1879).

80. *Dowdle v. Central Brick Co.*, 206 Ind. 242, 189 N. E. 145 (1934).

81. *Clarke Woodward Drug Co. v. Hot Lake Sanatorium Co.*, 88 Ore. 284, 169 Pac. 796 (1918). Of course this will not be true where the court is inclined to view after-acquired property clauses as invalid as against subsequent creditors. See WALSH, *MORTGAGES* (1934) § 10, 11; cf. *Benedict v. Ratner*, 268 U. S. 353 (1925) (future book accounts assigned); *Zartman v. First Nat. Bank of Waterloo*, 189 N. Y. 267, 82 N. E. 127 (1907). In the latter case, where the clause covered shifting stock but allowed the mortgagor the disposition and use of it until default, creditors were presumed to have relied on apparent ownership, though the mortgage provisions were recorded. See *id.* at 271, 82 N. E. at 128.

82. *Sarasota County v. Weeks*, 100 Fla. 1064, 130 So. 599 (1930).

83. *Coleman v. Booth*, 268 Mo. 64, 186 S. W. 1021 (1916).

84. Compare *Coleman v. Hagley*, 252 Mo. 102, 158 S. W. 829 (1913), with *Coleman v. Booth*, 268 Mo. 64, 186 S. W. 1021 (1916).

85. *Bowman v. Melnick*, 99 Colo. 311, 63 P. (2d) 464 (1936).

sold the business and taken notes and mortgages of the company to secure payment. Although the mortgages were of record, subsequent creditors had no notice that the corporation had received no new capital from the added debt and the transaction was held fraudulent as to them. Like cases⁸⁶ seem to promise success for subsequent creditors wherever a fraudulent transfer is made in the form of a mortgage, which though recorded does not bear on its face a statement of its purpose. This situation can be analogized to that in the watered stock cases, since in both creditors may recover at the expense of security holders who have not paid full value to the corporation. Such analogies may be useful in argument, but where a fraudulent transfer is considered sufficiently flagrant, subsequent creditors will probably be allowed to set it aside and doctrinal explanations are superfluous, whether they follow the line that fraudulent intent will be presumed,⁸⁷ or that the transfer was made with the knowledge that subsequent creditors might assume the corporate assets not to have been so dissipated.⁸⁸

The Uniform Fraudulent Conveyance Act has made no great change in this respect.⁸⁹ Section 7 requires "actual intent, as distinguished from intent presumed in law," to defraud future creditors before they may have a remedy. But Sections 5 and 6 provide that conveyances may be fraudulent as to subsequent creditors when made in the course of a business "for which the property remaining . . . is an unreasonably small capital, without regard to intent," or when the transferor "intends or believes that he will incur debts beyond his ability to pay." Conceivably under either of these sections, especially the former, subsequent creditors could attack any conveyance made by a corporation, already insolvent or thereby becoming so. But in the sixteen states where the Act has been enacted the cases indicate no increased tendency in this direction.⁹⁰ It may be that proof of reliance will not be required under

86. *In re Haas Co.*, 131 Fed. 232 (C. C. A. 7th, 1904); *cf.* *Johnson v. Canfield-Swiggart Co.*, 292 Ill. 101, 126 N. E. 603 (1920); *Clark v. E. C. Clark Machine Co.*, 151 Mich. 416, 115 N. W. 416 (1908). On similar facts it has been held that recorded bills of sale by the former owners put the public on notice as to the nature of the mortgage. *Shumpert v. National State Bank of Columbia*, 231 Fed. 82 (C. C. A. 4th, 1916).

87. *E.g.*, *Sarasota County v. Weeks*, 100 Fla. 1064, 130 So. 599 (1930). See Comment (1924) 37 HARV. L. REV. 489, treating conveyances in fraud of subsequent creditors in general.

88. *United States Rubber Co. v. American Oak Leather Co.*, 96 Fed. 891 (C. C. A. 7th, 1899); *In re Haas Co.*, 131 Fed. 232 (C. C. A. 7th, 1904); *Coleman v. Booth*, 268 Mo. 64, 186 S. W. 1021 (1916).

89. See, generally, McLaughlin, *Application of the Uniform Fraudulent Conveyance Act* (1933) 46 HARV. L. REV. 404.

90. Little use has been made of §§ 5 and 6. See 9 UNIFORM LAWS ANNOTATED (1932) 177, (Supp. 1937) 108. But see *McBride v. Bertch*, 58 F. (2d) 797 (W. D. Mich. 1930). Even where it is in force, the Uniform Act often passes unmentioned in the fraudulent conveyances cases, though subsequent creditors be favored [*Hemphill Co. v. Davis Knitting Co.*, 114 Pa. Super. 94, 173 Atl. 704 (1934)]; *cf.* *Powers v. Heggie*, 268 Mass. 233, 167 N. E. 314 (1929)] or disfavored. *Memphis Lumber Co. v. Security Bank & Trust Co.*, 143 Tenn. 136, 226 S. W. 182 (1920). But see *In re Haber's Estate*, 151 Misc. 82, 84, 270 N. Y. Supp. 603, 606 (Surr. Ct. 1934).

the Act, for neither of these sections makes provision for an application of the reliance theory. Thus if a right of recovery is recognized in any subsequent creditors, it will probably be recognized in all.

Whether the distinctions between creditors that have just been traced are justified is a question to which there is no ready answer; the validity of discriminating—like the type of discrimination—will vary in each situation. Since stock watering, failing to record a mortgage, or other false appearances of ownership can only injure relying creditors, it is plausible—at least in theory—to limit recovery to such creditors alone. But this survey has shown that courts and legislatures, recognizing the impracticability of proving reliance, have allowed creditors who conceivably could have relied to recover in all of these situations. Actually very few of the creditors who fall into this category are likely to rely. In a good many cases the creditor will not be aware of the “false representation,” for even cursory investigation of the debtor’s position is the exception rather than the norm. Certainly in watered stock cases the possibility that the creditor examined the debtor’s balance sheet is fairly remote. And even an insight into the true state of the debtor’s affairs will not necessarily dissuade the creditor from extending credit.⁹¹ There may be a somewhat greater likelihood of reliance in the unrecorded mortgage cases, for these cases are likely to involve small merchants whose visible possessions may have some effect on their credit standing.⁹² But at least in the watered stock cases, distinctions between creditors are of dubious validity, for few of the favored creditors are prone to extend credit in reliance on the false representations.

In the fraudulent conveyance field, it is said that recovery is granted to existing creditors because assets which they had a right to look to for satisfaction were wrongfully dissipated; recovery is denied to subsequent creditors, because they extended credit to an already denuded debtor. Unlike the “reliance” cases, here the practical administration of recovery corresponds to theory, but the theoretical basis of recovery is of questionable adequacy. For if no fraudulent conveyance were made, the property or its equivalent would be available to subsequent as well as to existing creditors. Furthermore, there is as much justification for the application of the reliance theory in this field as in the apparent ownership cases. Creditors who knew of fraudulent conveyances would be fully as reluctant to extend credit as those who knew that an appearance of affluence was misleading. Especially in the case of stock repurchases and unlawful dividend payments, creditors are as likely to rely on the debtor’s financial resources as they are in the case of watered stock. And abolition of the discrimination between creditors would

91. See note 25, *supra*; Comment (1937) 46 YALE L. J. 1177, 1207.

92. Since recordation does not in fact supply knowledge, creditors whose claims arose after delayed recordation may actually have relied on apparent ownership, and yet be denied recovery. This may seem to be an inconsistent result, but it is one which can not be avoided without a complete reversal of the policy back of the recording acts.

have an added virtue: it would minimize the administrative inconvenience now entailed by the necessity for proof of existence or subsequence.⁹³

Though there may not appear to be substantial grounds for preferring one group of creditors to another, it does not necessarily follow that the distinctions should be abolished. For if no distinction were made, recovery would either have to be denied or granted to all creditors. The first alternative seems clearly undesirable; indisputably creditors have been injured when property is fraudulently conveyed; and since false appearances of ownership will result in injury on some occasions, some sanctions at least are necessary in such cases. On the other hand, it is by no means clear that complete recovery is always justified. It is true that in the case of the typical fraudulent conveyance little sympathy need be wasted on the transferee; he is deprived only of an undeserved gain. But in other situations full recovery may impose an unwarranted penalty on the victim of the creditors' claims. In the watered stock cases, for example, the stockholders have actually not received any of the corporate assets, and great hardship may be entailed. While it may be justifiable to allow complete recovery against a promoter-stockholder, it is decidedly less equitable to impose such a penalty on a small investor who unsuspectingly received a bonus of common stock with his purchase of preferred. Similarly, the granting of indiscriminate recovery in the unrecorded mortgage field imposes a penalty far greater than the damage that could possibly have been inflicted by the omissions of the mortgagee. Distinctions between creditors on a basis of possible injury, then, serve the purpose of preventing undue castigation of mortgagees and watered stockholders. But there appears no reason why in the fraudulent conveyance field at least, recovery should not be allowed to all creditors.⁹⁴ And as has been shown courts who wish to reach this result have satisfactory devices readily available.

Since claims unavailable to the debtor are asserted by creditors only when other expedients prove unsatisfactory, they will often not be made until the debtor's estate is under the administration of a bankruptcy or receivership court. While generally the trustee or receiver may sue in the right of the most favorably situated creditors,⁹⁵ much the same problems found in the

93. It may often happen that a creditor has been extending credit over a period of time. In a watered stock case, for example, he may thus be under a heavy burden to prove that the debts remaining unpaid arose after the stock transaction and before he acquired knowledge of it. *Rickerson Roller-Mill Co. v. Farrell Foundry & Mach. Co.*, 75 Fed. 554 (C. C. A. 6th, 1896).

94. Although the distinctions between existing and subsequent creditors were abandoned, knowledge of or participation in a fraudulent transfer might still be held to bar a creditor from recovery without inconsistency. *Cf.* notes 47, 61, *supra*. The doctrine of "clean hands" need lose none of its force.

95. See, generally, Comments (1936) 45 *YALE L. J.* 504, (1935) 33 *MICH. L. REV.* 1059, 1067; (1937) 46 *YALE L. J.* 1229; *cf.* (1938) 38 *COL. L. REV.* 523. No attempt has been made in this Comment to consider the special problems arising under assignments

analysis of individual actions are raised in slightly different form by two issues: the amount of recovery to be allowed and the method of its distribution. Where an individual creditor is suing, it is clear that recovery will be had only to the extent of his claim and for his benefit alone.⁹⁶ The same rationales which lead to this result, if applied in receivership or bankruptcy, point to recovery only to the extent of the claims of creditors, who would themselves have been in a position to recover, and distribution of the property exclusively to them. Insofar as recovery is allowed to a greater extent or distribution is made to others as well, it is apparent that the theories vesting certain creditors with rights to the exclusion of others are no longer controlling.

Whether or not these theories should be allowed to control in bankruptcy or receivership is a question which depends on the same considerations raised in the foregoing discussion of the validity of the distinctions made between creditors and the protection to be accorded the victim of their claims. The conclusion there reached was that in general such protection might necessitate the retention of distinctions otherwise valueless. In bankruptcy or receivership, however, unlike individual actions, it is possible to treat the two problems separately. For the arbitrary discrimination between creditors can be eliminated by allowing ratable distribution of the property recovered to all. At the same time the "victim" can be protected by limiting the amount of recovery. A decision in favor of equal distribution, which is probably always desirable, even if only for its simplicity and ease of administration, is thus not subject to criticism on the ground that it necessarily entails unlimited recovery.⁹⁷ Unquestionably, the devotee of consistency will object that so long as the distinctions are made when individual creditors are suing, there can be no reason for their abandonment in receivership or bankruptcy.⁹⁸ Just as secured creditors are not robbed of their priority under

for the benefit of creditors. For the power of the assignee to sue, see Comments (1938) 47 YALE L. J. 944, 956, (1936) 45 YALE L. J. 504, 509.

96. Even if a creditor's action be in behalf of all those similarly situated who may wish to join, distribution can not go beyond the members of that class. *E.g.*, *Braun v. American Laundry Mach. Co.*, 56 F. (2d) 197 (S. D. N. Y. 1932). Presumably a successful action by any one creditor would give imperative force to the claim of any similarly situated creditor, at least for purpose of settlement.

97. Some commentators seem to have assumed the contrary. See note 130, *infra*. If distribution is to be only to favored creditors, however, it follows of necessity that recovery will be limited to the claims of that class. On the other hand, a prior determination of the amount of recovery forecloses no possibilities as to methods of distribution. If recovery is to be limited, a wide variety of methods is available. See appended table, p. 1192, *infra*. If recovery is not to be so limited, it is probable that equal distribution to all creditors will follow, but it has been argued that in such case the favored creditors should first be satisfied in full and that only the balance of the property recovered should go to the remaining creditors. See *In re Lewis Co.*, (62 F. (2d) 353, 354 (C. C. A. 5th, 1932)).

98. Analogy may be drawn from the proposition that property which is non-exempt only as to certain creditors does not pass to the estate in bankruptcy for the benefit of all creditors. *In re Neumaier*, 11 F. Supp. 341 (S. D. N. Y. 1935).

judicial administration,⁹⁹ it may be said, so creditors with an added source for the satisfaction of their claims should not be denied their advantage. But there can be no reason for adhering to a rule when, as has been shown, the reasons for following that rule have disappeared. Whatever the merits of these opposing arguments, courts have chosen to dispose of these problems without reference to broad policy justifications, but almost solely on the basis of general theories as to the status of representatives of creditors.

As early as 1873 the United States Supreme Court said, "It is well settled, where a deed is set aside as void as to existing creditors, that all the creditors, prior and subsequent, share in the fund *pro rata*."¹⁰⁰ This rule seems to have been accepted by the bankruptcy courts without much question in the fraudulent conveyance field,¹⁰¹ especially since the case of *Globe Bank and Trust Co. v. Martin*.¹⁰² It is true that an occasional dissenting voice¹⁰³ seeks to distinguish away this case on the ground that equal distribution there resulted only because existing creditors had obtained a lien within four months of the bankruptcy;¹⁰⁴ for under Section 67(f) of the Bankruptcy Act a lien obtained within four months, if preserved by the trustee, operates for the benefit of the whole estate.¹⁰⁵ But, rightly or wrongly, the *Globe Bank* case has been repeatedly cited as authority for the broader proposition that under Section 70(a) and (e) the trustee may set aside for the benefit of the whole estate any transfer made in fraud of any creditors.¹⁰⁶

99. It is to be noted that if a favored creditor obtains a valid lien on fraudulently transferred or apparently owned property before the four months period, this lien will entitle him to priority in bankruptcy and there will be no question of equal distribution. Bankruptcy Act § 67(d); cf. *Metcalf v. Barker*, 187 U. S. 165 (1902). On the other hand, if such a lien is obtained within four months, it is voidable and inures to the benefit of the whole estate. See note 105, *infra*. Thus, the issue of equal distribution *vel non* can arise only if there is no lien of any kind on the property.

100. See *Kehr v. Smith*, 20 Wall. 31, 36 (U. S. 1873); *Oliver v. Brennan*, 292 Fed. 197, 201 (N. D. Cal. 1923), *aff'd*, 299 Fed. 106 (C. C. A. 9th, 1924).

101. *In re Moore*, 11 F. (2d) 62 (C. C. A. 4th, 1926); *Campbell v. Dalbey*, 23 F. (2d) 229 (C. C. A. 5th, 1927); *Cohen v. Schultz*, 43 F. (2d) 340 (C. C. A. 3d, 1930); *In re L. H. Lewis Co.*, 62 F. (2d) 353 (C. C. A. 5th, 1932). The last case cited sought to distinguish *American Trust & Savings Bank v. Duncan*, 254 Fed. 780 (1918), note 103, *infra*, which arose in the same Circuit Court of Appeals, but in effect overruled it.

102. 236 U. S. 288 (1915).

103. *American Trust & Savings Bank v. Duncan*, 254 Fed. 780 (C. C. A. 5th, 1918); *Dodd v. Raines*, 1 F. (2d) 658 (N. D. Ga. 1924) (bulk sale); *Costello v. Emmick*, 122 Misc. 114, 203 N. Y. Supp. 123 (Sup. Ct. 1923).

104. See *American Trust & Savings Bank v. Duncan*, 254 Fed. 780, 783 (C. C. A. 5th, 1918).

105. *First National Bank of Baltimore v. Staake*, 202 U. S. 141 (1906).

106. See cases cited note 101, *supra*. For an explicit interpretation of the case as holding to this effect, see *In re Moore*, 11 F. (2d) 62, 64 (C. C. A. 4th, 1926). It is noteworthy that whenever property is said to be distributed "to all creditors" or "for the benefit of the estate," it will necessarily be subject to any priorities existing in the general assets. Thus, it is not inconceivable that those creditors who were favorably situated as to a fraudulent transfer might receive nothing from the property recovered. Cf. *Watkins v. Seaberry*, 261 U. S. 571 (1923).

Much more uncertain, however, is the question as to the extent of the trustee's recovery.¹⁰⁷ Since under Section 67(e) he may set aside fraudulent conveyances made within the four months period in his own statutory right,¹⁰⁸ it is probable that he may void such transfers completely.¹⁰⁹ But under Section 70(e) he may attack other fraudulent conveyances only in the right of creditors who might have done so.¹¹⁰ Even though Section 70(a) is repeatedly said to give the trustee title to the fraudulently transferred property,¹¹¹ it may be argued that he is vested with title only to the extent that the property was fraudulently transferred, that is, to the extent of the claims of existing creditors. On the other hand, simply because it is admitted that the trustee is in no better legal position than the creditors whom he represents,¹¹² it may not be accurate to say that he is merely subrogated to their rights.¹¹³ The precedent on both sides is unsatisfactory.¹¹⁴ Most of the cases seeming at first to favor the total setting aside of fraudulent transfers are revealed on closer inspection to be based on the belief that the transfers were intentionally fraudulent to subsequent and existing creditors.¹¹⁵ And cases which hold that there can be no recovery where there was no favorably situated creditor,¹¹⁶ or that the recovery will be distributed only to the favored creditors,¹¹⁷ while they preclude the application of the unlimited recovery rule, are not authority against it. The rare cases directly in point seem to favor recovery *in toto*.¹¹⁸ Irrespective of the intricacies of

107. For the sake of simplicity, it will be assumed throughout the following discussion that complete recovery is needed in order to satisfy all creditors.

108. See *Frost v. Latham*, 181 Fed. 866, 870 (C. C. Ala. 1910); *In re Gray*, 47 App. Div. 554, 557, 62 N. Y. Supp. 618, 620 (1st Dep't, 1900).

109. But cases, surprisingly enough, are lacking. This may be due to the fact that the proposition has been taken for granted. On the other hand, it may be that, since creditors would rarely be subsequent to such conveyances and the latter would be void in any case as against all existing creditors, the problem has not arisen.

110. See 4 REMINGTON, BANKRUPTCY (4th ed. 1935) 319.

111. See *Globe Bank v. Martin*, 236 U. S. 288, 296 (1915); *In re Kohler*, 159 Fed. 871, 873 (C. C. A. 6th, 1908); *Cohen v. Schultz*, 43 F. (2d) 340, 342 (C. C. A. 3d, 1930).

112. *Scales v. Holje*, 41 Cal. App. 733, 183 Pac. 308 (1919).

113. See *In re Gray*, 47 App. Div. 554, 557, 62 N. Y. Supp. 618, 620 (1st Dep't, 1900), quoted in *Scales v. Holje*, 41 Cal. App. 733, 735, 183 Pac. 308, 309 (1919).

114. One source of confusion has been those cases where a fraudulent transfer is set aside *in toto* pending the determination of existing creditors' claims and in contemplation of a return of the surplus to the transferee. *Cunningham v. Mitchell*, 126 Wash. 294, 218 Pac. 386 (1923); *McCrory v. Donald*, 119 Miss. 256, 80 So. 643 (1919).

115. *Davis v. Gates*, 235 Fed. 192 (M. D. Pa. 1916); *Goetz v. Newell*, 183 Wis. 559, 198 N. W. 368 (1924). Where this is the case, there will be no question but that all creditors will share ratably in the proceeds, not excluding the transferee if he have a *bona fide* claim. *Buffum v. Barceloux Co.*, 289 U. S. 227 (1933); *In re Kohler*, 159 Fed. 871 (C. C. A. 6th, 1908) (suit settled).

116. *Scales v. Holje*, 41 Cal. App. 733, 183 Pac. 308 (1919).

117. *Dodd v. Raines*, 1 F. (2d) 658 (N. D. Ga. 1924).

118. *Watkins v. Sedberry*, 261 U. S. 571 (1923); *In re Lewis Co.*, 62 F. (2d) 353 (C. C. A. 5th, 1932). But cf. *Bergin v. Blackwood*, 141 Minn. 325, 170 N. W. 508 (1919) (transfer in fraud of estoppel creditors). See, also, note 132, *infra*.

statutory interpretation these decisions seem justifiable on broader grounds of policy, for the claims of innocent creditors in the conveyed property should be held superior to those of fraudulent transferees, at least where the latter acted in collusion with the transferor.¹¹⁰ Whatever rules are adopted for the typical fraudulent conveyance, it may be surmised, though cases are rare, that the same will be applied to the stock repurchase and unlawful dividend situations.¹²⁰

In the unrecorded mortgage field, there has been considerably more confusion. It seems, however, that where the mortgage or conditional sale is never recorded, or not recorded until after the filing of the petition in bankruptcy, all creditors, including those whose claims arose before the mortgage or sale agreements, will share ratably.¹²¹ This result is said to follow from the Amendment of 1910 to Section 47(a) providing that the trustee has all the rights of a lien creditor as of the time the petition was filed;¹²² since such a creditor could set the mortgage aside, the trustee sues in his own right,¹²³ and hence for the benefit of the whole estate. But this rationalization is of questionable soundness. In part at least the trustee's right is derived from creditors; for state statutes generally provide that notice of the real ownership destroys the claim even of a lien creditor,¹²⁴ and the view that Section 67(a) makes the trustee a lien creditor without notice is in the minority.¹²⁵ The generally prevailing rule is rather that he must represent at least one creditor without notice.¹²⁶ But even though the trustee derives

It is to be noted that here, as elsewhere, the state statutes, which determine the trustee's cause of action, may cause variation in the absolute amount of recovery possible.

119. There are at least three types of fraudulent transferees, those who were in collusion with the transferor, those who drove a hard bargain with him and are later held not to have given consideration, and those who received preferences within the four-month period. Obviously the latter two may be deserving of some consideration, even as against innocent creditors. But when "fraudulent transferee" is used in this comment, it is intended to refer to the first type only unless the context indicates otherwise.

120. *Lytle v. Andrews*, 34 F. (2d) 252 (C. C. A. 8th, 1929).

121. *Townsend v. Ashepoo Fertilizer Co.*, 212 Fed. 97 (C. C. A. 4th, 1914); *In re Frost*, 12 F. (2d) 1 (C. C. A. 6th, 1926); *In re Rosen*, 23 F. (2d) 687 (D. Md. 1928); *In re Myers Motor Sales Co.*, 1 F. Supp. 509 (S. D. Tex. 1932). But cf. *Firestone Tire & Rubber Co. v. Gross*, 17 F. (2d) 417 (C. C. A. 4th, 1927).

122. 36 STAT. 840 (1910), 11 U. S. C. § 75(a) (1934); *In re Farmers' Cooperative Co. of Barlow*, 202 Fed. 1008 (D. N. D. 1913); *In re Rosenthal*, 238 Fed. 597 (S. D. Ga. 1916), distinguishing *Simmons v. Greer*, 174 Fed. 654 (C. C. A. 4th, 1909).

123. See *In re Farmers' Cooperative Co. of Barlow*, 202 Fed. 1008, 1009 (D. N. D. 1913).

124. See, e.g., CAL. CIV. CODE (Deering, 1937) § 2973; N. Y. PERSONAL PROPERTY LAW § 65.

125. E.g., *Townsend v. Ashepoo Fertilizer Co.*, 212 Fed. 97 (C. C. A. 4th, 1914).

126. Usually the trustee has the burden of proving this fact. *National Bond & Inv. Co. v. Jones*, 78 F. (2d) 601 (C. C. A. 6th, 1935); *In re Douglas Lumber Co.*, 2 F. (2d)

from individual creditors his status as a creditor without notice, it is now clearly settled that when a mortgage has not been recorded at the time of the filing of the petition the trustee may recover for the benefit of the whole estate.¹²⁷ And the cases seem to intimate that he will also be allowed unlimited recovery.

The chief difficulty in the past has been in the situation where the mortgage was recorded before the filing of the petition. Since the trustee is in the position of a creditor whose rights accrue only at the time the petition was filed, he can only recover in the rights of creditors who extended credit before recordation.¹²⁸ But the conflict as to the method of distribution in this situation seems to have been finally settled in the case of *Moore v. Bay*,¹²⁹ wherein the Supreme Court, through Mr. Justice Holmes, said that "The rights of the trustee by subrogation are to be enforced for the benefit of the estate." It has been sometimes assumed that the same case necessarily laid down the rule that an unrecorded mortgage might be set aside completely, even if it exceeded in amount the claims of the favorably situated creditors.¹³⁰ Since there is no indication in the record of the case that this situation existed, certain equivocal phrases in the opinion are the only apparent evidence to support this assumption.¹³¹ But other language in the case submits to an opposite construction. Indeed an argument might be drawn from the sentence quoted above, for rights by subrogation can scarcely exceed their origins. At the very least it seems clear that this issue remains in doubt in the unrecorded mortgage field,¹³² and it is at best of doubtful wisdom to inflict

935 (D. Wyo. 1924); cf. *General Motors Acceptance Corp. v. Raz Delivery*, 238 App. Div. 277, 264 N. Y. Supp. 412 (4th Dep't, 1933). But some cases require the mortgagee to prove that all creditors had notice. *In re Master Knitting Corp.*, 7 F. (2d) 11 (C. C. A. 2d, 1925). But see dissenting opinion of Learned Hand, J. Here again variations may be due to peculiarities of local law as to the effect of notice, etc.

127. See notes 121, 122, *supra*.

128. *In re New York Economical Printing Co.*, 110 Fed. 514 (C. C. A. 2d, 1901); *In re Myers*, 24 F. (2d) 349 (C. C. A. 2d, 1928) (only debtor's equity in the mortgaged property distributed for benefit of whole estate).

129. 284 U. S. 4 (1931), (1932) 41 YALE L. J. 629. It does not necessarily follow that this rule will be applied in the "estoppel creditor" cases [see notes 10-12, *supra*], where the court seems to consider the creditor's claim of a more personal nature. *Hart v. Casterton*, 56 N. D. 581, 218 N. W. 644 (1928); cf. *Bergin v. Blackwood*, 141 Minn. 325, 170 N. W. 508 (1919).

130. See Scott, *Recordation Provisions in Bankruptcy Act* (1931) 18 VA. L. REV. 249, 265, 268; (1932) 45 HARV. L. REV. 579. But see (1932) 41 YALE L. J. 629.

131. "The question raised is whether the mortgage is void also as against those who gave the bankrupt credit at a later date, after the mortgage was on record." See *Moore v. Bay*, 284 U. S. 4, 5 (1931). However, an analysis of the mandate handed down by the court in the light of the record of the case may lead to a conclusion that this question was answered in the negative, contrary to superficial appearances. See *Buffum v. Maryland Casualty Co.*, 88 F. (2d) 547, 548 (C. C. A. 9th, 1937).

132. In a recent case *Moore v. Bay* was cited to support a holding that a fraudulent \$1200 mortgage should be set aside *in toto*, though existing creditors' claims were only \$55.91. It was not clear, however, that only existing creditors were in a position to set it aside. *In re Doderick*, 91 F. (2d) 646 (C. C. A. 10th, 1937).

a penalty on the mortgagee out of all proportion to the injury possibly occasioned by failure to record.

Even greater uncertainty surrounds the treatment of these problems in the receivership courts. In general it has been suggested that the rules of distribution in receivership should follow those laid down for bankruptcy,¹³³ and probably at least in a fraudulent conveyance case the receiver should distribute the proceeds to all creditors.¹³⁴ A fair guess can be made that the same result has been reached in recordation cases denying the mortgagee's or conditional vendor's claim for priority,¹³⁵ but at least one receivership court has specifically followed a procedure other than that of equal distribution in this field.¹³⁶ As to amount of recovery there is no positive indication that it has ever been allowed to exceed the favored creditors' claims.

In the watered stock cases, the issue of equal distribution *vel non* is affected and confused by the uncertainty as to whether a trustee or a receiver can sue at all on such claims. Although most courts probably allow such actions,¹³⁷ others have said that if the creditors' claim against the stockholder is based on fraud and deceit, that is, on the reliance theory, it cannot be maintained by a trustee;¹³⁸ still others, that where the right exists only in some creditors and not in all, a receiver is helpless.¹³⁹ At least partially because of this difficulty,¹⁴⁰ receivers or trustees may often attempt to frame the cause of action in terms of unpaid subscriptions. If the action is so framed, there will be no favored creditors, and the trustee's or receiver's recovery will be for the benefit of all.¹⁴¹ Where suit is allowed on a watered stock theory, the

133. *Levin Co. v. Star Jewelry Co.*, 54 R. I. 465, 175 Atl. 651 (1934).

134. *Washington Mill Co. v. Sprague Lumber Co.*, 19 Wash. 165, 52 Pac. 1067 (1893). But see *Braun v. American Laundry Mach. Co.*, 56 F. (2d) 197, 200 (S. D. N. Y. 1932).

135. *Cornelius v. C. C. Pictures*, 297 Fed. 444 (C. C. A. 2d, 1924); *Samuel Olson & Co. v. Voorhees*, 292 Fed. 113 (C. C. A. 3d, 1923); *Wood v. Cox*, 92 N. J. Eq. 307, 113 Atl. 501 (Ch. 1921); *National Bread Wrapping Mach. Co. v. Cowl*, 137 Wash. 621, 243 Pac. 840 (1926).

136. See notes 162, 163, *infra*.

137. *Trustee: In re Phoenix Hardware Co.*, 249 Fed. 410 (C. C. A. 9th, 1918); *Grand Rapids Trust Co. v. Nichols*, 199 Mich. 126, 165 N. W. 667 (1917); *Compton v. Perkins*, 144 Ore. 346, 24 P. (2d) 670 (1933). *Receiver: Lex v. Selway Steel Corp.*, 203 Iowa 792, 206 N. W. 586 (1925); *Berry v. Rood*, 168 Mo. 316, 67 S. W. 644 (1902); *Wolcott v. Waldstein*, 86 N. J. Eq. 63, 97 Atl. 951 (Ch. 1916).

138. *Courtney v. Georger*, 228 Fed. 859 (C. C. A. 2d, 1915); *Courtney v. Croxton*, 239 Fed. 247 (C. C. A. 6th, 1917); *Thomason v. Miller*, 4 S. W. (2d) 663 (Tex. Civ. App. 1928); *cf. In re Huffman-Salvar Roofing Paint Co.*, 234 Fed. 793 (N. D. Ala. 1916).

139. *Marion Trust Co. v. Blish*, 170 Ind. 686, 84 N. E. 814 (1903); see *Hirschfeld v. McKinley*, 78 F. (2d) 124, 135 (C. C. A. 9th, 1935) (trustee); *cf. Farnsworth v. Wood*, 91 N. Y. 307 (1883). See, in general, (1937) 46 *YALE L. J.* 1229.

140. Another reason may be the desire to frame the action in favor of existing creditors, as well as subsequent. *Cf.* p. 1169, *supra*.

141. *Livingston v. Adams*, 226 Mo. App. 824, 43 S. W. (2d) 836 (1931); *Palmer v. Scheffel*, 194 App. Div. 682, 186 N. Y. Supp. 84 (1st Dep't 1921); *cf. Scovill v. Thayer*, 105 U. S. 143 (1881). There is no question but that a trustee or receiver can recover

result as to distribution cannot be so easily predicted. The few cases that have explicitly dealt with the issue are inconsistent.¹⁴² Most significant is a Circuit Court of Appeals decision upholding the action of a trustee in bankruptcy in compromising a watered stock claim and dividing it ratably among all creditors, over the protest of certain creditors whose right against the stockholders might have entitled them to 100% recovery.¹⁴³ The court, noting the trustee's dilemma, suggested that assets recovered by him in the right of favorably situated creditors might have been distributed to all and cited the *Globe Bank* case as analogous. Since *Moore v. Bay*, decided subsequently, would be much stronger authority for such a proposition, like results are perhaps the more to be expected in the future. Again in this field, there has been no definitive determination on the issue of amount of recovery.¹⁴⁴

Though fairly well established in the bankruptcy field, the equal distribution rule is not universally applied in the receivership courts. Where the recovery is to inure to the benefit of the favored creditors, a whole new set of problems and alternatives arise with respect to the method of distributing assets. But little help as to the appropriate method of distribution can be obtained from the reported cases, for with one or two exceptions the courts have successfully avoided the issues. One explanation for the dearth of definitive decisions may be that the tendency is to settle the difficulties by negotiation in the receivership or bankruptcy court itself. Another plausible solution is that the rule of equal distribution, which avoids the problem, is more universal than the decided cases would indicate. In any case the almost complete absence of authority leaves the field open for the suggestion of possibilities.

For purposes of clarity in exposition it seems essential to assume a hypothetical case. Since the use of a single set of figures may convey a misleading impression, in the appended table on page 1192, *infra*, various rules of distribution are applied to three situations, which vary, not as to the claims, but as to the amount of property available. In the discussion which follows in the text, however, reference will be made only to the first, situation A.

It is supposed that a corporation has debts of \$3000, \$1000 of which is secured by a mortgage on property worth \$1000. The remaining assets available for distribution amount to \$1000. The mortgage, however, is invalid as against a group of "subsequent creditors" with claims of \$1000, because of delay in recordation. It is valid as against "existing creditors," who also have

unpaid subscriptions. *Allen v. Ryan*, 219 App. Div. 634, 221 N. Y. Supp. 77 (4th Dep't 1927); see *Gilmer v. Wilcox*, 194 Wis. 107, 109, 215 N. W. 827, 828 (1927).

142. Compare *Jones Co. v. Home Oil & Development Co.*, 124 La. 148, 49 So. 1009 (1909) (equal distribution), with *Berry v. Rood*, 168 Mo. 316, 67 S. W. 644 (1902).

143. *Petition of Stuart*, 272 Fed. 938 (C. C. A. 6th, 1921).

144. While the distribution issue is ever present when there are differently situated creditors, the extent of recovery may often be a purely academic question, for it arises in fact only where the possible recovery exceeds the claims of favorably situated creditors. That this is an unlikely eventuality is perhaps indicated by the paucity of decisions on the point.

claims of \$1000. The mortgagee's claim is undisputed, so that at worst he ranks as an unsecured creditor.

The basis for the first group of methods to be considered is the premise that the subsequent creditors are to have a preferred claim on the mortgaged property to the exclusion not only of the existing creditors, but of the mortgagee as well. The problems arise solely as to the distribution of the general assets. Proceeding upon the classical principle of marshalling assets—that a creditor with two sources for the satisfaction of his claim must first have recourse to that which is available to him only¹⁴⁵—in methods (a) and (b) of type I the subsequent creditors first collect the mortgaged property and then if necessary prove in the general estate.¹⁴⁶ The issue remains as to whether they may still prove their total original claims and share *pro rata* on that basis, a procedure known as the "equity rule";¹⁴⁷ or whether they may only prove as to the balance unpaid on their claims, according to the "bankruptcy rule."¹⁴⁸ The consequence of the latter is obviously to reduce their return in favor of both the other groups.¹⁴⁹ The former is in accordance with the strict rule that the doubly secured creditor must not be prejudiced by the application of the doctrine of marshalling.¹⁵⁰

By forcing the subsequent creditors to exhaust their remedies against the mortgaged property before allowing them to prove in the general estate, the rule of marshalling favors the existing creditors at the expense of the mortgagee. An alternative method would be to compel the favored creditors, along with the disfavored creditors and the mortgagee, to seek first their *pro rata* share in the general estate. Then the mortgaged property would go to the subsequent creditors to the extent necessary to satisfy their claims,

145. See, e.g., *First National Bank of Boston v. Proctor*, 40 F. (2d) 841, 843 (C. C. A. 1st, 1930).

146. This was the rule applied in *In re Cannon*, 121 Fed. 582 (D. S. C. 1903), a bankruptcy case before the Amendment of 1910. See note 122, *supra*. Since the fund in dispute arose solely from the property mortgaged, only the first step in the method is indicated. The various results in this type of situation are shown in situation C of the appended table.

147. *Merrill v. National Bank*, 173 U. S. 131 (1899). White, Harlan, McKenna, JJ., dissenting, favored the "bankruptcy rule."

148. *Old First Nat. Bank & Trust Co. v. Scheuman*, 13 N. E. (2d) 551 (Ind. 1938). For a collection of cases supporting these and two other less important rules, see Note L. R. A. 1918 B 1021. Cf. Bankruptcy Act § 57(e) and (h); *In re Mayer*, 41 F. (2d) 856 (D. Pa. 1930).

149. Under situation A in the appended table, according to the type I rules, there is no need for the subsequent creditors to prove in the general assets; therefore there is no difference between I(a) and I(b). Situation B in the table has been laid out for the purpose of showing the different results that may attend the application of the "equity rule" or the "bankruptcy rule."

150. See *People v. Remington & Sons*, 121 N. Y. 328, 333, 24 N. E. 793, 794 (1890); cf. *Woman's Hospital v. Sixty-Seventh St. Realty Co.*, 265 N. Y. 226, 234, 192 N. E. 302, 306 (1934).

the mortgagee retaining any balance.¹⁵¹ Since under this method the subsequent creditors must make primary resort to the estate, the chances that there will be a surplus left in the mortgaged property for the mortgagee are enhanced; he is thereby benefited at the expense of the existing creditors.¹⁵² It may also be noted that this method, I(c), like the "equity rule" of marshalling, gives the preferred group the greatest possible advantage over the others,¹⁵³ for it allows full proof of the favored creditors' claims in the general estate.

There seems, however, to be no commanding reason for the assumption thus far made that the preferred creditors should receive the benefit of all the mortgaged property. It may be urged that though not itself fraudulent, an unrecorded mortgage violates a statute intended to prevent fraud, and that strong penalties are needed for enforcement.¹⁵⁴ But the danger that the mortgage may be invalidated even as to a limited group of creditors is certainly a severe enough sanction. Exclusive distribution to subsequent creditors, then, can be supported only if it is assumed that the subsequent creditor might not have extended credit at all had he known of the mortgage; but this premise is at best of doubtful validity.

It is equally reasonable to place the subsequent creditors in the position they would have been in, had the mortgaged property been in fact unencumbered. To accomplish this, it is sufficient to deprive the mortgagee of his security; there is no reason to penalize him further by relegating him to a position behind the subsequent creditors, for, unlike a fraudulent transferee, he has a *bona fide* unsecured claim. A possible basis of distribution then would be a ratable sharing of the mortgaged property between the mortgagee and the subsequent creditors.¹⁵⁵ This rule, designated as type II,

151. See method I(c). This seems to be the effect of a suggestion made by one commentator. See Carey and Cilella, *supra* note 10, at 1020. Surprisingly, however, it seems to have been intended as an application of the rule of marshalling.

152. This will always be true as compared with the "bankruptcy rule" of marshalling, I(b), but will be true as compared with the "equity rule," I(a), only when under the latter rule preferred creditors may obtain 100% satisfaction without taking a full *pro rata* share of the general estate; for since under the reverse marshalling method they will take a full *pro rata* share, they would not need to avail themselves of all the mortgaged property and a surplus would be left for the mortgagee.

153. An even more complete sacrifice of the rights of the disfavored creditors was apparently contemplated by the lower federal courts in the case of *Moore v. Bay*, 284 U. S. 4 (1931). The favored creditors were to be given 100%, then the mortgagee was to get the full amount of the mortgage, and the remaining assets were to be distributed to the creditors against whom the mortgage was valid. Appellant's Brief, p. 5. This method is not reproduced in the appended table, because no possible logical basis for it can be found.

154. See *Steele v. Mansell*, 6 Rich. L. 437, 453 (S. C. 1852), cited with approval in *In re Cannon*, 121 Fed. 582 (D. S. C. 1903), note 146, *supra*.

155. This proposition enjoys the support of an authority. *In re Myers*, 24 F. (2d) 349 (C. C. A. 2d, 1928). Note, however, that this bankruptcy case would now probably come under the rule of *Moore v. Bay*, 284 U. S. 4 (1931).

varies from type I chiefly in giving the mortgagee a share of the mortgaged property previously allocated exclusively to the preferred group.¹⁵⁶ The type II rule is, of course, subject to the same variations as type I, with the same tendencies apparent in each.

While the type II method diminishes the windfall which favored creditors would receive under type I, it fails to take accurate account of the extent to which the subsequent creditors have been harmed. The subsequent creditors extended credit on the basis of an apparent state of facts, and it is only necessary to recreate that state of facts as far as they are concerned in order to do them justice. Since subsequent creditors expected that the mortgaged property, as well as the general assets, would be distributed *pro rata* to all creditors, they should receive the share they would have had if this had been the case.¹⁵⁷ In the example chosen this is one third of the total assets available, including the mortgaged property.¹⁵⁸ The problem remains as to the distribution between the mortgagee and the existing creditors. Clearly the latter have no claim to any of the mortgaged property. On the other hand the mortgagee is entitled to share in the general assets on the basis of any deficiency in the satisfaction of his claim, just as he would have if for any reason his security had fallen short of his claim. The procedure for reaching this result is inevitably complicated. The mortgaged property should be divided first, on the principle just outlined, the preferred creditors taking, in the example, one third, the mortgagee the remaining two thirds because the mortgage is valid as against the existing creditors. Then, following the "bankruptcy rule", the mortgagee and the subsequent creditors should prove the unpaid balance of their claims in the general estate¹⁵⁹ together

156. There may be a further variation. Under the "equity rule" existing creditors will be better off under type I if the subsequent creditors' claims can be satisfied without taking a full *pro rata* share of the general assets, except when under both types I and II subsequent creditors can be satisfied completely out of the mortgaged property. Compare I(a) with II(a). The occurrence of this exception is extremely improbable, for in type II the subsequent creditors can be completely satisfied out of the mortgaged property only if it is also sufficient to satisfy the mortgagee completely.

157. This was the rule applied by the referee who was reversed by the court in *In re Cannon*, 121 Fed. 582 (D. S. C. 1903), note 146 *supra*. See *id.* at 583. Since only mortgaged property was available, the mortgagee got the balance. See method III in situation C in the appended table.

158. It may thus be seen that in the type II methods as well as those of type I, the preferred group is receiving more than it would have if there had been in fact been no mortgage. Since this was the apparent situation on which it supposedly relied, it is in effect receiving a premium for being deceived.

159. In the unlikely event that the mortgaged property exceeds the mortgagee's claim, it should be divided between subsequent creditors and mortgagee only up to the amount of the mortgagee's claim; the excess should be included in the "general estate." Although admittedly the existing creditors will thereby be allowed to share in part of the mortgaged property, this is an inevitable consequence if the subsequent creditors are to receive their actual damages and the existing creditors what they would have had if the mortgage had been valid. In any event, except in certain extremely improbable

with the existing creditors who prove their full claims. This will be seen to effect the result that the existing creditors receive exactly what they would have received if the mortgage had been valid, which it was as to them.¹⁶⁰ Thus they are not penalized by the failure of the mortgagee to record, which would be the effect if they received any less.¹⁶¹ Exactly the same result as that here contemplated was reached by the Supreme Court of South Carolina,¹⁶² but the method of computation used, while fully as complicated, was more in the nature of a "rule of thumb," and unless somewhat modified might often give an improper result.¹⁶³ The slight mistake made, however,

situations, the mortgagee will still get more than under any of the type I or type II methods.

160. The reason for this result is as follows: If the mortgage had been valid, the existing creditors would have shared *pro rata* in the general assets with the subsequent creditors and the mortgagee to the extent of his claim which was not satisfied by the mortgaged property. (In situation A, the mortgagee's claim would have been wholly satisfied by the mortgaged property, hence he would not have had to share in the general assets). In the method proposed, the mortgaged property is distributed between the mortgagee and the subsequent creditors, and the subsequent creditors' claims in the general assets are decreased by the same amount that the mortgagee's claim is increased. Hence the total claims with which the existing creditors will share *pro rata* in the general assets also remain the same.

It has seemed justifiable in reaching this result to assume that, if the mortgage had been valid but the property had not wholly satisfied the mortgagee's claim, he would prove in the general assets only on the basis of his deficiency claim, *i.e.*, according to the "bankruptcy rule." Accordingly, the system of calculation here employed would have to be somewhat modified, if the "equity rule" were to prevail.

161. If the bankruptcy rule is employed, existing creditors receive the same in type I and type II as they do in type III, except where the amount of the mortgaged property exceeds the mortgagee's claim.

162. *In re American Slicing Machine Co.*, 125 S. C. 214, 118 S. E. 303 (1923).

163. The computation was as follows: The percentage of subsequent creditors' claims which they were to recover was ascertained by dividing the total assets including the mortgaged property by the total claims including the mortgagee's claim. The percentage of recovery for the existing creditors was determined by dividing the general assets by the claims of the unsecured creditors, *i.e.*, the total claims less the mortgagee's claim. The mortgagee was given the balance. This will give the right result only so long as the mortgagee's claim is exactly equal to the value of the mortgaged property. For example, if the mortgaged property has depreciated below the mortgagee's claim, the existing creditors will get too much at the expense of the mortgagee, for the method contemplates no claim against the general estate by the mortgagee. This is readily demonstrable: In situation B in the appended table, where the mortgaged property amounts only to \$500, according to the rule of the Slicing Machine case, each of the three groups of creditors would get \$500. This is the proper amount for the subsequent creditors, but obviously something is wrong if the existing creditors get as much as each of the other two. A correct result, however, can be assured if the rule is modified as follows: In calculating the percentage of recovery for the existing creditors, the value of the mortgaged property (though only to the extent of the mortgagee's claim) should be deducted from the total claims. Then the value of the general assets (plus any surplus mortgaged property) should be divided by this amount. In the case supposed, this would give the existing creditors 40% recovery, instead of 50%, or \$400. See result in rule III, situation B.

does not detract from an eminently intelligent decision, unique in its understanding of the issues involved.

The unrecorded mortgage situation, chosen here as most convenient and complete for the purposes of illustration, is not exactly analogous to those cases where the victim of the special claim has himself no *bona fide* claim against the estate, as in the typical watered stock or fraudulent conveyance cases. The problems that arise when the rule of equal distribution is not followed in these situations, are similar to those already discussed and can be dealt with along the same lines. They are simply not so complicated.¹⁶⁴ For example, if the reasoning of rule III (actual damage) be employed, the stockholders can be held only for the increment which would have been added to the favored creditors' share if the estate had been as they expected it to be.¹⁶⁵ In both situations, the favored creditors could be accurately compensated by computing their *pro rata* share in the special claim just as if all the other creditors were entitled to share in it. The remainder of the special claim would be left to the transferee or stockholder.¹⁶⁶ Similarly, the type I methods might be applied, in which case the favored creditors would be given complete priority over the transferee or stockholder in the distribution of the transferred assets. The effects of the different ways of marshalling are the same: the "bankruptcy rule" benefits the disfavored creditors at the expense of the favored group, while the reverse marshalling process, method (c), is hardest on the disfavored group and easiest on the victim of the claim. Since in these situations, neither the transferee nor the stockholder has a claim against the estate, the type II methods are inapplicable, as there could be no reason for ratable distribution between the claimant and his victim. An illustrative table similar to that for the unrecorded mortgage situation appears on the next page.

There being no inherent value in any of the rules of distribution outlined, the choice of method can depend only on the individual attitude towards the parties concerned. Again it seems that where the victim is a fraudulent transferee or a stockholder-promoter who has consciously deceived the public, type I(a) or (b) should be followed, for under these rules the favored creditors receive complete priority over the transferee. On the other hand, if the claim involves a small stockholder who in all good faith received some bonus shares or a dividend which he has long since spent, the hardship of imposing out-of-pocket liability may indicate that rule III should be applied

164. In no case will the transferee or stockholder be allowed to share in the general assets.

165. Similarly, a transferee can be held only for the increment which would have been added to the favored creditors' share if there had been no fraudulent conveyance.

166. Note, however, that in dividing the general assets the "equity rule" should here be applied, since the "actual damage" method proceeds upon the assumption that the disfavored creditors ought to receive only that to which their position entitles them: a *pro rata* share in the general assets.

and the preferred creditors be given no more than the extent of actual damage to them. There is, however, no ground for supposing that such a theory has ever been applied in these fields, and in practice the probability is that recovery would be along one of the more typical marshalling or type I rules. The only remaining dispute then would be as to the relative merits of the equity and bankruptcy rules for proving in the general assets. Of these the "bankruptcy rule" is probably the better, since it does not overemphasize the discrimination between the favored and disfavored group.

METHODS OF DISTRIBUTION IN UNRECORDED MORTGAGE SITUATION

				Existing (disfavored) Creditors	Mort- gagee	Subsequent (favored) Creditors
		CLAIMS:		1000	1000	1000
Situations		Methods		Distribution		
A.	I	(a)	(equity rule)	500	500	1000
Gen'l	I	(b)	(b'k'cy rule)	500	500	1000
Assets: 1000	I	(c)	(reverse marsh.) ..	333	666	1000
Mortg'd	II	(a)	(equity rule)	333	833	833
Prop.: 1000	II	(b)	(b'k'cy rule)	500	750	750
	II	(c)	(reverse marsh.) ..	333	833	833
	III		(actual damage rule)	500	833	666
			(Equal distribution)	666	666	666
B.	I	(a)	(c) (equity rule) ...	333	333	833
Gen'l	I	(b)	(b'k'cy rule)	400	400	700
Assets: 1000	II	(a)	(c) (equity rule) ...	333	583	583
Mortg'd	II	(b)	(b'k'cy rule)	400	550	550
Prop.: 500	III		(actual damage rule)	400	600	500
			(Equal distribution)	500	500	500
C.	I	(a)	(b) (c)	0	0	500
Gen'l	II	(a)	(b) (c)	0	250	250
Assets: 0	III		(actual damage rule)	0	333	166
Mortg'd			(Equal distribution)	166	166	166
Prop.: 500						

METHODS OF DISTRIBUTION IN FRAUDULENT CONVEYANCE TYPE SITUATION

				Subsequent (disfavored) Creditors	Fraud. Trans- feree	Existing (favored) Creditors
		CLAIMS:		1000	....	1000
Situations		Methods		Distribution		
A.	I	(a)	(b)	1000	....	1000
Gen'l Assets: 1000	I	(c)		500	(500)	1000
Fraud'ly Transf'd	III		(actual damage rule)	500	(500)	1000
Prop.: 1000			(Equal distribution)	1000	....	1000
B.	I	(a)	(c)	500	....	1000
Gen'l Assets: 1000	I	(b)		666	....	833
Fraud'ly Transf'd	III		(actual damage rule)	500	(250)	750
Prop.: 500			(Equal distribution)	750	....	750
C.	I	(a)	(b) (c)	0	....	500
Gen'l Assets: 0	III		(actual damage rule)	0	(250)	250
Fraud'ly Transf'd			(Equal distribution)	250	....	250
Prop.: 500						

Note: In the watered stock situation the position of subsequent and existing creditors would be exactly reversed.